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RETURN TO PRIVATE MORTGAGE INSURANCE

DURING the 1930's the majority of private insurance companies engaged in the business of insuring lenders from loss on mortgage loans withdrew from the mortgage loan insurance aspect of their operations. In an effort to fill the void that resulted in this field, various Federal policies were initiated in order to satisfy the continuing demand for this type of insurance.

On May 14, 1934, President Roosevelt relayed a special message to Congress requesting the passage of a Federal program that would assume the mortgage insurance and other real estate functions formerly operated by private business. On the first day (June 18) of the 1934 Congressional session, the National Housing Act was approved and became a law on June 27, 1934. This action brought about the emergence of the Federal Housing Administration and later the loan guaranty program of the Veterans Administration in 1944. The insurance activities of the FHA and the mortgage loan guarantee efforts of the VA have enjoyed an unchallenged "monopoly" in the mortgage field for the last three decades. The reserves accumulated by the FHA and the direct Government appropriations available to the VA have served to steadily strengthen these organizations. These factors, coupled with the memories many private lending institutions have about the failures of mortgage insurance companies during the Depression, have generally deterred private enterprise from re-entering the field. But the last few years have seen the rise of private investment interest in the mortgage insurance function, with one major firm growing in stature and others likely to follow. It is the intention of this article to point out the possible reasons for the renewed private interest in the mortgage loan insurance business, and to show the probable procedures under which the private segment will operate.

Through their mortgage activities, both the FHA and VA have contributed greatly to the real estate sector of our economy since their inception. In the past twenty years, for instance, the FHA has been able to insure over $40 billion worth of home loans. But, inherent in the operation of both the FHA and the VA are disadvantages which seem to provide the stimulus for the current private activities in the mortgage loan insurance business. Interest rate inflexibility, application processing procedures, and methods of claim

payment seem to compose the major drawbacks to the operations of these agencies.

The present FHA interest maximum of five and three-quarters percent and the VA maximum of five and one-quarter percent are too low to cause active interest on the part of the majority of mortgage lenders in our present money market. Lengthy application processing and excessive bookkeeping responsibilities seem to be involved in FHA and VA mortgage loan procedures. And finally, claim settlement by issuance of twenty-year interest-bearing debentures rather than cash is considered a disadvantage to many lenders. Thus, if private ingenuity can offset the aforementioned disadvantages and still maintain the safeguards offered by the FHA and VA, a renewed era in private mortgage insurance operations may be emerging.

In practice, the majority of private firms that re-enter the mortgage loan insurance business will seek to provide mortgage insurance which will protect lending institutions from losses on single-family, first-mortgage loans. In the mortgage loan "ladder" of risk, we find at one extreme the high-quality, large downpayment, conventional type loan that most institutions readily accept without any thoughts of mortgage loan insurance requirements. At the bottom of the risk "ladder" we can place the poor quality, low downpayment, poor credit type of loan, of which the majority of lenders immediately disapprove.

Between these two extremes fall the greatest number of present-day loan applications. These loan requests usually involve situations where a high ratio of loan to appraised value is required in order for the applicant to be able to purchase the property. Through the efforts of the FHA and VA, lenders have been able to extend this type of loan because the risk of loss is minimized by Federal insurance or guarantee, the cost of which is mainly borne by the borrower. It is in this middle area that the private mortgage insurance firms hope to make inroads. For a premium the mortgage loan insurer will assume in part, or in total, the risk of loss attributed to this category of loans.

The majority of loans accepted by the leading private insurer must typically meet several requirements. The loan must be secured by a first mortgage which does not exceed 80 percent of the appraised market value of a nonowner-occupied property, or 90 percent of the appraised value of an owner-occupied property. It is obvious that the majority of loans meet the 90 percent qualification. For approval, the loan has to be amortized with a monthly payment covering principal, interest, taxes, and insurance, and have a term of less than thirty years. The property must be improved with a nonfarm residence or a semicommercial building, at least 50 percent of which is under residential use by one to four families. Naturally, the financial condition of the borrower is subject to approval in all cases.

Although the requirements mentioned in the previous paragraph appear to be quite liberal, the issuance of mortgage guarantee insurance generally depends on the result of a condition imposed by the lender. For example, most lenders will not require mortgage loan insurance on loans which constitute less than 50 percent to 80 percent of the appraised market value of the property. On the other hand, it will not receive applications for loan insurance on loans exceeding a 90 percent relationship to the appraised market value because savings and loan associations, the principal users of this type of insurance, are limited to 90 percent loans unless backed by a Government agency. This also applies to other types of lending institutions which are, for the most part, limited to a percentage lower than a savings and loan association. Based on these requirements, it is reasonable to assume that private mortgage loan insurers will have to compete for the loans which have an appraised loan-to-value relationship that is high enough for the lending institution to require insurance, but that does not exceed the 90 percent limit on savings and loan associations and the lower limits imposed on other approved mortgage lenders.

Because the recent activities in the field of mortgage loan insurance are still in the development stage, experience concerning defaults cannot be deemed adequate. One of these firms anticipates that its loss experience will parallel that of the FHA because it plans to deal only with approved and selected lending institutions. As of this writing it has disapproved loans to speculative developers. In reality, the top twenty percent of a typical first mortgage loan is insured. Therefore, its loss on a defaulted mortgage is twenty percent of the lender's full claim. In case of default, it appears that the company has a choice of trying to dispose of the property itself, or of assuming the twenty percent loss. As previously mentioned in this article, one of the major strengths of the FHA has been its reserve accumulation policy. The leading company's present procedure is to establish reserves which total sixty percent of its gross premium income. Using the same loss experience as the FHA, it maintains its total reserves equal to 110 times the current loss ratio. The present FHA reserve coverage is approximately 120 times its current loss ratio. Only as this and other private mortgage loan insurance companies develop their loss exposure experience can the true value of these reserve policies be discerned.

The leading firm in this field does not currently maintain a full appraisal staff. It depends on the lender to make a fair appraisal, but in order to insure that the judgment of the lender is consistent with the appraisal policies of the company, a local independent appraiser spotchecks every third mortgage approved for coverage. If a lender's appraisals are running higher than deemed satisfactory, the lender receives an immediate request for improvement. If the lender does not conform, then the privilege of self-appraisal is withdrawn. Here is another area where experience will serve to point out the effectiveness of a policy.

Fluctuations in defaults on first mortgages do not follow a steady pattern when related to the economy in general. Since the late thirties, even periods of recession have failed to bring about any excessive increase in defaults. The true test of any enterprise of this type would be its effectiveness under the stress of a major depression. Since such a test is impossible, it is the responsibility of each lending institution to weigh the advantages and disadvantages offered by private mortgage loan insurers to the policies of their respective institutions. We believe that there is a potential for private enterprise in this field as long as a policy of conservatism prevails.

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